The View *from* Burgundy

JULY 2012

Investing in Deflationary Times

It has been 14 years since Burgundy began investing in Japanese stocks. While we have generated a reasonably positive rate of return, the experience has been challenging and at times frustrating. Plagued by ballooning government deficits and debt, aging demographics, poor corporate governance and a corporate sector hobbled by increasing global competition and a strong currency, the Japanese economy has stagnated. While many of the Japanese companies we own have done well in this environment – generating high profit margins and returns on capital, producing tremendous free cash flow (most of which is now being distributed to owners through dividends and share buybacks), increasing their market shares and so on – they have not been immune to the sluggish domestic economy or the declining investor interest in Japanese companies.

Japan's economy was a poster child for rapid growth and development in the '60s, '70s and '80s, but over the past 20 years it has managed a mere 1% growth rate in real terms. In contrast to the rest of the world, particularly the developing economies, Japan's poor performance over the last two decades has stood out. During these "lost decades," we have seen the country's economic might and geopolitical relevance diminish dramatically.

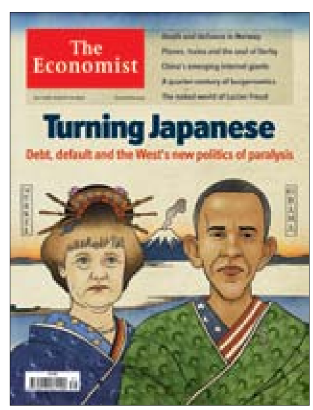
Until recently, the long stagnation of the Japanese economy has been regarded as an anomaly and an experience unlikely to be replicated elsewhere in the world. For example, Masaaki Shirakawa, governor of the Bank of Japan, recently told an audience at the London School of Economics, "At various international meetings I have attended in the past 10 years or so, policy-makers and academics often have not seriously discussed the issue of stagnant growth in Japan, simply dismissing it as an idiosyncratic failure of Japan's society and its policy-makers to respond to problems in a swift and bold manner." Indeed, in 14 years of studying Japan and investing in Japanese companies, Burgundy has grown accustomed to hearing economists and investors state that Japan's stagnant growth experience was unnecessarily drawn out and painful due to ill-timed and inadequate Japanese policy responses.

But is Japan's situation really so idiosyncratic? Reflecting on Burgundy's experience investing in this environment, we cannot help but notice Japan is no longer an outlier. The aftermath of the global financial crisis has been characterized by slow growth and high unemployment, as well as an increase in fiscal deficits, government debt loads, political instability and general distrust of capital markets across both the U.S. and Europe – a pattern very familiar to anyone who has followed Japan since the collapse of its credit-fuelled real estate and stock market bubbles in the late '80s. With this in mind, we believe investors may benefit from the lessons we have learned investing in Japan over the last 14 years. Specifically, in uncertain times, investors should stick to quality companies and remain patient and disciplined.

Turning Japanese

The Economist drew attention to the economic similarities among the U.S., Europe and Japan with its July 2011 cover showing President Obama and German Chancellor Merkel dressed in kimonos under the headline, "Turning Japanese." George Soros, one of the most successful investors of all time, whose views on investing and economic issues are widely followed, recently stated in *Newsweek*, "The situation is about as serious and difficult as I've experienced in my career. We are facing an extremely difficult time, comparable in many ways to the 1930s, the Great Depression. We are facing now a general retrenchment in the developed world, which threatens to put us in a decade of more stagnation, or worse. The best-case scenario is a deflationary environment. The worst-case scenario is a collapse of the financial system."

Burgundy is not a macro investor and eschews making any top-down macroeconomic forecasts. While we don't ignore the macro economy, we would rather focus our efforts on bottom-up, company-by-company research than top-down macroeconomic analysis. As Warren Buffett has said, "Investors should price, rather than time, purchases. It is folly to forgo buying shares in an outstanding business whose long-term future is predictable because of short-term worries about an economy or a stock market that we know to be unpredictable. Why scrap an informed decision because of an uninformed guess?" Yet, as investors in companies, we are acutely aware that the macroeconomic environment has a direct influence on the companies we own. Deflation is rare and particularly tough on business. The increasing prospect of an emerging harsh global economic and business climate warrants a closer look at any relevant experience. And, Japan's experience over the past 20 years may be disturbingly relevant to today's issues.

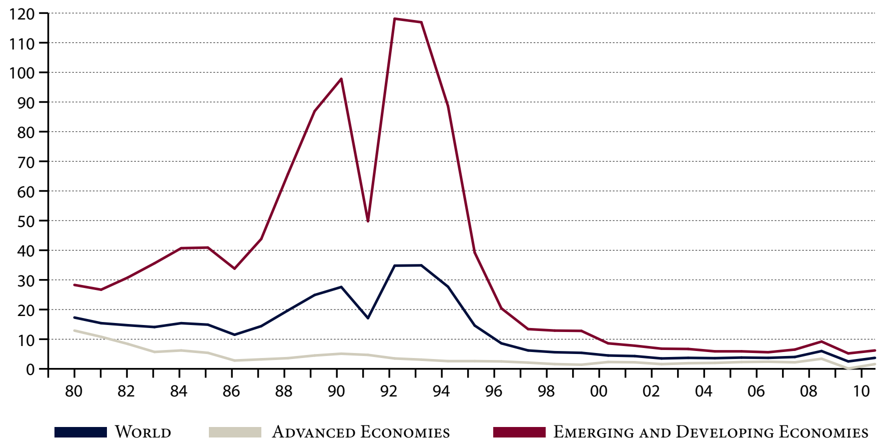


The Dangers of Deflation

Over the past 75 years, there have been only three significant episodes of deflation in the U.S., with the last taking place in 1949. The world has had a similar experience. Over the past 40 years, for example, the world consumer price index (as shown in Figure 1) has seen inflation (in some countries even hyperinflation) and a significant period of disinflation, but no deflation. Remarkably, Japan has had quite the opposite experience. In contrast to the world's experience, Japan has been in deflation for most of the last two decades (see Figure 2)!

FIGURE 1

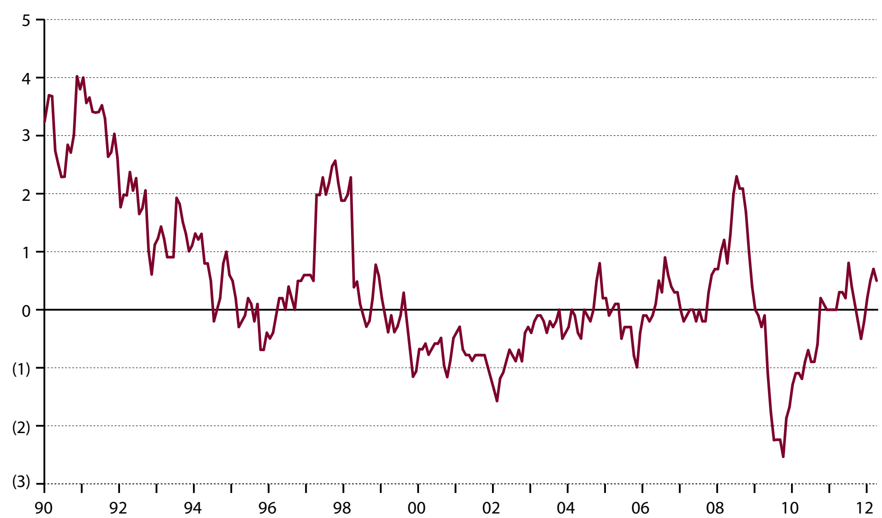
WORLD CONSUMER PRICE INFLATION
1980 – 2010 (% PER ANNUM)



(Source: Dr. Peter Warburton, "Practical History of Financial Markets" course at the Edinburgh Business School)

FIGURE 2

JAPAN INFLATION RATE: CHANGE ON CONSUMER PRICE INDEX
JANUARY 1990 – 2012 (% PER ANNUM)



(Source: rateinflation.com)

Deflation hurts an economy in a number of ways:

- **Steadily falling prices of goods and services wreak havoc on businesses.** Given that labour costs are sticky, profits fall as prices fall. Eventually, businesses respond to falling profits by cutting labour costs, causing unemployment to rise. As unemployment rates rise, wages tend to fall. As wages fall, demand for goods and services suffers, putting further pressure on prices and on businesses. A downward spiral develops.

- **Persistently falling prices give rise to the paradox of thrift.** When consumers expect prices to fall, they delay or forgo many purchases. If everyone simultaneously attempts to save rather than spend, total savings in the population decline because of the decrease in overall consumption and economic growth. Central bankers prefer inflation to deflation, some saying they will do whatever it takes to prevent this demand-deficit situation from arising.

- **Sales growth in a deflationary environment is very difficult to achieve.** In deflation, businesses cannot rely on the organic growth drivers of steadily rising prices and volume. In absence of mergers and acquisitions, a world of deflation forces companies to scale down to reduce costs. Paradoxically, a smaller-sized business struggles to compete in a world where low cost and low prices are the critical factors of success.

- **Deflation coincides with dramatic declines in real estate and stock market prices, resulting in widespread destruction of wealth.** Deflation causes the real value of debt to rise. Therefore, using debt to help fund purchases of homes and stocks (which is very common in normal inflationary periods) becomes toxic in deflationary periods and leads to a quickening of the wealth-destruction process. Falling house prices, for example, lead to higher loan-to-value ratios for homeowners. If price declines are severe enough, home equity can disappear, leading to mortgage defaults and forced selling. Widespread consumer deleveraging is common in deflation and is very destabilizing for markets, as well as the overall economy. It is a fertile environment for what Nassim Nicholas Taleb calls "Black Swan" events.

- **Deflation robs an economy of dynamism because it favours savers over borrowers and the elderly over the young.** Poor investment performance and extreme volatility in risky asset prices eventually dampen the "animal spirits." Outside of government bonds, there is nowhere for investors to hide and eventually people begin to prefer cash and cash equivalents over any other investment alternative.

- **For governments and policy-makers, deflation makes traditional monetary policy ineffective.** With fewer levers to pull, governments must rely on fiscal stimulus to help the economy. There are, however, political and economic limits to government spending. Furthermore, common policy responses to problems caused by deflation (such as financial system instability, high unemployment, rising social instability, etc.) usually have long-term negative consequences that impede economic growth. For example, low interest rates help companies avoid failure, but they slow down restructuring. Government bailouts secure employment but impede industry realignment and rationalization. Increasing government fiscal deficits help stabilize the economy but lead to a crowding out of private-sector investment.

Deflation and Business

Given how tough deflation is on the economy, it is not surprising that very few companies (at least as far as their stock prices are concerned) do well in such an environment. Figure 3 shows stock price performance of the Tokyo Stock Exchange's 33 industry sectors since 1998, when deflation first took hold in Japan.* The Japanese stock market average is down approximately 40% since 1998 and many sectors of the market are down even more!

While on the surface it appears the average investor does very poorly investing in a deflationary environment, we caution against drawing any firm conclusions. The aggregate stock price performance masks a tremendous disparity of performance among companies in each industry. For example, while the technology hardware and equipment industry suffered an average stock price decline of 43% since 1998, Canon Inc. (a constituent of that group) saw its stock price increase! Based on our experience, and supported by a closer look at the data, stock price and company performance are linked to factors other than deflation. Such factors include high initial stock prices (i.e., valuation), industry regulatory changes, globalization and competition. The bottom line is that, while investing in a deflationary environment is challenging, not all companies (and investors) suffer a similar fate.

FIGURE 3

STOCK PRICE PERFORMANCE OF JAPAN'S INDUSTRY SECTORS 1998 – 2011

Industry Classification Benchmark Sector	Performance	# of Firms
Alternative Energy	245%	1
Mining	167%	2
Tobacco	161%	1
Oil Equipment, Services & Distribution	67%	1
Pharmaceuticals & Biotechnology	64%	39
Mobile Telecommunications	28%	5
Automobiles & Parts	21%	125
Industrial Metals & Mining	21%	70
Industrial Transportation	5%	70
Chemicals	4%	158
Health-Care Equipment & Services	2%	32
Industrial Engineering	(3%)	247
Support Services	(4%)	84
Aerospace & Defence	(5%)	4
Gas, Water & Multi Utilities	(6%)	17
Food & Drug Retailers	(6%)	53
Food Producers	(6%)	121
General Industrials	(10%)	36
Oil & Gas Producers	(12%)	9
Electronic & Electrical Equipment	(18%)	189
Personal Goods	(18%)	92
Travel & Leisure	(19%)	94
Household Goods & Home Construction	(22%)	69
Leisure Goods	(25%)	29
Forestry & Paper	(28%)	12
General Retailers	(28%)	142
Software & Computer Services	(29%)	51
Real Estate Investment & Services	(31%)	36
Media	(32%)	28
Construction & Materials	(32%)	247
Beverages	(35%)	14
Technology Hardware & Equipment	(43%)	90
Electricity	(46%)	10
Banks	(50%)	73
Fixed Line Telecommunications	(55%)	1
Financial Services	(56%)	41
		2,293

(Source: Tokyo Stock Exchange)

*Note: we are not using stock price performance dating back to 1990, when Japan's housing and stock market bubbles burst, because the consumer price index was still positive.

Lessons Learned Over the Years

Burgundy's experience investing in Japan's deflationary environment over the last 14 years has taught us a few things. Here are some of the insights we have acquired and lessons we have learned.

- **A deflationary environment is the opposite of a "rising tide lifts all boats" environment.** More than in any other environment (inflationary, disinflationary and hyperinflationary), the quality of businesses and their management matters. Companies with enduring competitive advantages and strong balance sheets, generating high margins, returns on capital and generous amounts of free cash flow, do well during deflation (largely at the expense of weaker competitors). Investors in these companies have profoundly different experiences in deflationary periods than the average indexed investor.
- **Investors should look for companies that can consistently differentiate their products or services (brands, quality and pricing) from their peers.** Pricing power is rare in a deflationary environment; therefore, ordinary companies will find it difficult to grow. Investors should look for companies that excel at new product development and that can find ways to grow market share without sacrificing margins or profits. Also, look for businesses with sufficient geographical diversity to offset weak domestic demand. Organic growth in a deflationary environment will not be accidental.
- **Low cost disruptors do well in deflation as market-share growth offsets falling prices.** Disruptors, or companies that make a competing product at a much lower cost, actively use low price as their main strategy. Incumbent competitors who do not want to sacrifice profits are often reluctant to compete with disruptors on similar terms. The loss of market share (i.e., volume) and severely declining prices (brought about by the disruptor strategy) create an extremely challenging environment for all but the new competitor. With an absence of growth, investors should focus on companies that are cost competitive.
- **Companies with debt perform poorly relative to those without debt.** Deflation causes the real value of assets to fall and the real value of debt to rise. A company's balance sheet comes to matter as "good credits" (companies with strong balance sheets and fundamentals) are able to borrow easily and cheaply while "bad credits" (companies with poor balance sheets and fundamentals) are starved of capital.
- **Banks and financials perform very poorly.** Banks suffer from a lack of demand for loan growth, net interest margin ("spread") compression due to intense competition, and a constant pressure to increase provisions as deflation eats away at asset values and the collateral values against those assets. Provisions and writeoffs eventually erode a bank's equity (and the banking industry's equity), giving rise to insolvency concerns. Industry insolvency concerns lead to credit rating downgrades, rising borrowing costs and forced asset sales. This should sound familiar to anyone following the European banking industry today.
- **Capital-intensive and commodity businesses suffer greatly in a deflationary environment.** Volume growth is critical for these businesses, but hard to come by in deflation. Usually when volumes fall for a capital-intensive business, so do its margins and cash flows. Falling cash flows lead to rising debts. Remember, the use of debt and leverage during deflation is a toxic formula.

- **Traditional Ben Graham statistical valuation methods do not work well.** Seth Klarman, founder and president of Baupost Group, a very successful and widely admired investment partnership, explained in his famous book on value investing, *Margin of Safety*, "In a deflationary environment, assets tend to decline in value. Buying a dollar's worth of assets for 50 cents may not be a bargain if the asset value is dropping. The possibility of sustained decreases in business value is a dagger at the heart of value investing (and is not a barrel of laughs for other investing approaches either). Value investors place great faith in the principle of assessing value and then buying at a discount. If value is subject to considerable erosion, then how large a discount is sufficient? Should investors worry about the possibility that business value may decline? Absolutely."
- **Deflationary periods are characterized by rising concerns of systemic risks and extreme levels of uncertainty; corporate management and investors will require patience and discipline to have success.** However, this is easier said than done. Very few management teams or investors have experience operating or investing during an extended period of harsh economic climate, causing them to underestimate the challenges and changes that take place.

Quality, Patience, Discipline

Will the developed world suffer a similar fate to that of Japan? Will the U.S. and European economies experience a long period of stagnant growth and deflation or, as George Soros has warned, far worse? While there are many views on the subject, no one knows!

Deflationary environments are characterized by uncertainty and volatility. This is especially true when deflation results from the bursting of a credit-fuelled bubble, as was the case in Japan. Richard Koo, author of *The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession*, would say that one should not underestimate the extent of damage caused by a balance sheet recession (another way of saying deflation) and the time required to deal with it. The larger the bubble, the longer it will take to mend. Too many people today believe that swift and bold government and central bank policy can get the world out of any mess. Based on Burgundy's investing experience in Japan, we are skeptical of this view.

However, while most investors are fleeing the stock market to seek safety in government bonds, we remain upbeat on the prospects for our portfolios. At the end of the day, our experience in Japan has taught us that investors can make money in the most uncertain times by focusing on quality companies and remaining patient and disciplined.

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